DOW THEORY LETTERS INC.

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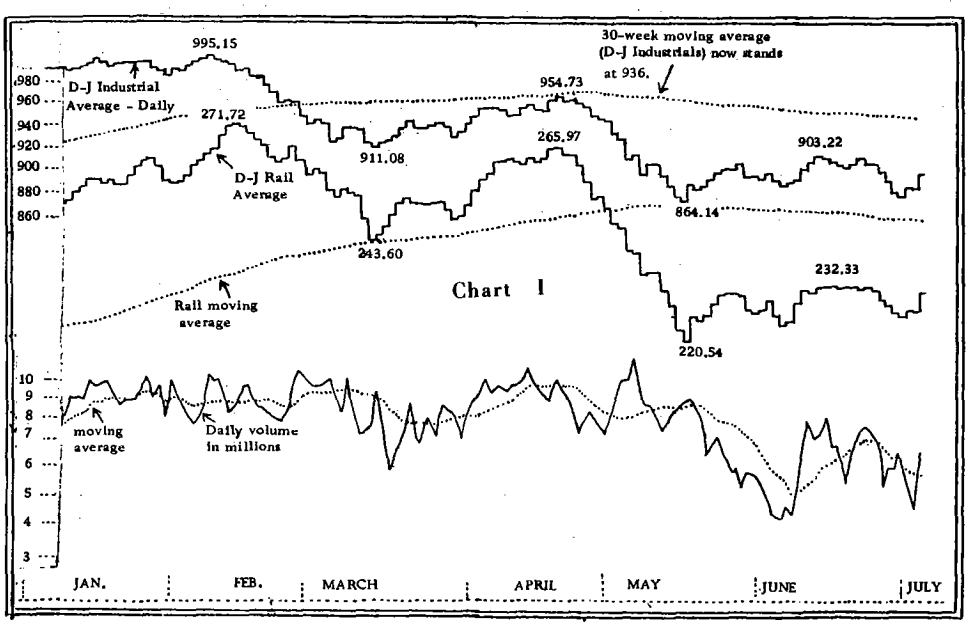
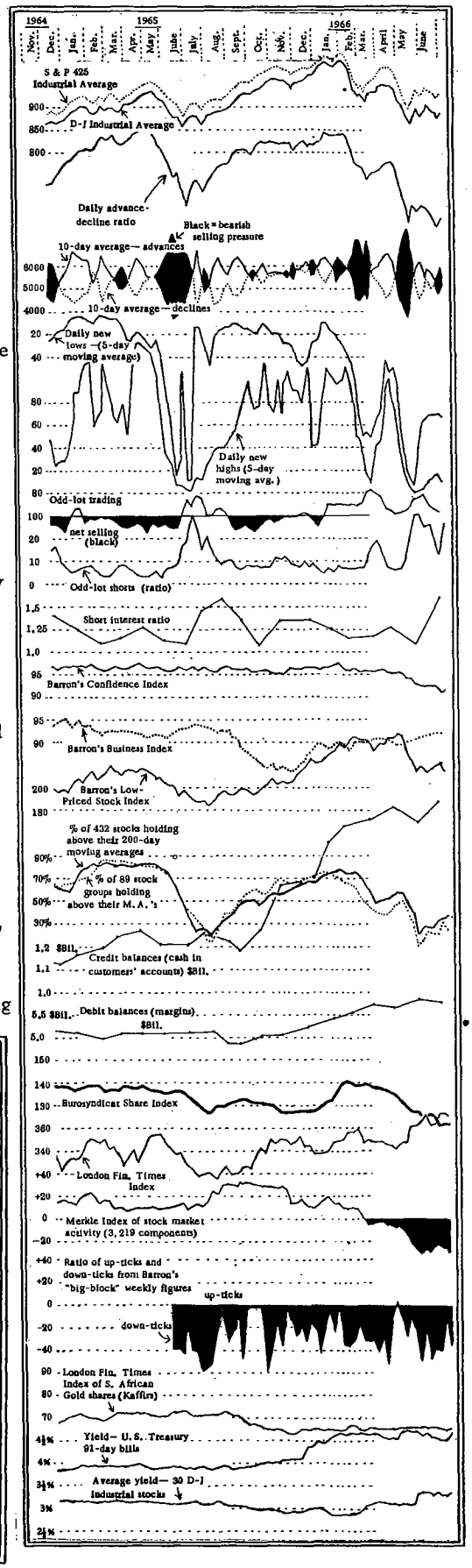
THE MARKET: There is an "old adage" in this business (an adage which I coined myself) which goes like this: "When you've been right on the trend for a few months in this business, don't push your luck!" I have been very cautious during all of 1966, and, of course, when the primary bear signal was given on May 5, I announced a primary bear market and turned completely bearish. The D-J Industrial Average dropped 131 points from the February high of 995.15 to the May 17 low of 864.14, and many analysts are now of the opinion that this was enough of a drop to discount any and all of the bearish and doubtful eventualities which can be seen ahead.

A friend of mine was in the office this morning, and he was reading the myriad investment services which arrive here at the beginning of each new week. I noted that his face assumed an increasingly perplexed look. "Take it easy, Bill," I remarked, "if you read enough in this business you can go out of your mind." "I know," he replied as he thumbed through a stack of services, "I've just read every opinion about the market that it is possible to give, and I'm about out of my mind now."

What is my opinion? I have found simplicity is often a help when attempting to figure what is ahead. I believe that we are now in a primary bear market. When whatever rallying phase of this current movement has exhausted itself, I believe that new lows on the Averages will be seen. As this is written, there is still some "life" or upside activity in about 30 or 40 specialty stocks on the Board. These stocks include many Airlines, some Electronics and a few Color-TV stocks although the latter (as stated in the last Letter) have for the most part topped out. Motorola and Admiral, two leaders of a month ago, are now in states of collapse.

There is little doubt that as long as one or both Averages (i.e. Industrials and Rails) hold above their 1966 lows of 864.14 and 220.54 respectively, there will be a large segment of Wall Street and the investing public which will hold to the bullish line ("the lows for 1966 have been seen"). But whether the Averages trace out one more upward movement above the June highs or whether they plunge in the next week below the lows of May, I believe the die is cast for this market. Before the summer is out (perhaps sooner than anyone thinks) the primary bear trend should reassert itself, and the 1966 lows should be violated. When this happens everyone will know that the bear market is here in earnest, and it should be the beginning of panic or semi-panic conditions. The next major "support line" below 864.14 is the 1965 low of 840.59 for Industrials. When that level is smashed the bear market will be on with a fury, and it will be too late to sell anything




1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows — (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

intelligently and unemotionally. For this reason, I continue to urge my subscribers to move out of their stocks and into the protected position of cash (U.S. Treasury 91-day bills).

The market will have to tell its own near-term story, and as I write this first part of the Letter I cannot tell whether immediate new weakness is fated to come in or whether the rally of last Friday (July 1) is to be followed by further strength. However, the violent four-day drop of June 27-30 illustrates how abruptly the primary forces can make their appearance. On July 30 the Industrials dropped temporarily below the 864.14 1966 low, only to rally and close above that point. July 1 followed with additional rallying power. A veteran analyst once told me, "I never trust an up-Friday in a down week." Such days often smack of short covering, particularly before long weekends. But I once again suggest to my subscribers that they forget the day-to-day or short-term considerations and instead do what long-term investment policy dictates in a bear market—get out and sit with cash until the primary bear forces spend themselves.

In recent Letters I have suggested that subscribers keep an eye on all four major D-J Averages, Industrials, Rails, Utilities and the 40 Bonds. During a bear market it is normal for steady "leakage" to occur with first one, then the other, then three or all four Averages breaking into new low ground. On Tuesday, July 5, the 40 Bonds sank to a new low of 83.14 (lowest level since 1961).

NOTES AND QUOTES: I have recently been rereading Robert Rhea's service for the period of the 1937-38 bear market. The following paragraph struck me as particularly interesting, and it might be placed under our "The more things change, the more they are the same department." This was written on December 1, 1937: "Those....who did not sell are now giving many reasons for failure to act. Some of the reasons are: reluctance to incur tax liability; unwillingness to forego dividends; fear of inflation; waiting for the rally; belief in the managed economy; and the almost universal bullish opinion of soothsayers.....Hamilton once said that pride of opinion had ruined more men than gambling and whiskey combined. It undoubtedly caused the downfall of many people in recent months. Every market, however, must have its quota of wishful thinkers. All investors cannot sell at the same time, and every stock and bond must have an owner at sundown."

* * *

Last year Americans spent more than $4½ billion for mutual funds. This was more than the entire U.S. foreign aid program, a staggering figure. I believe that this is a record which will stand for a long time to come.

Which indirectly brings me to another subject. There is a basic change which I perceive taking place across the nation. It might be termed "the end of the go-go psychology." Suddenly people are talking to each other; they are thinking and they are looking around. Doubts are cropping up. The President of the United States is being questioned; his popularity is ebbing. People are beginning to wonder where they are going and where the country is going. It's as if the nation has had "one too many" and is beginning to sober up after the wild party. It is a slow and subtle change, and it is being reflected perhaps most accurately in popular music. The pop stations are currently coming forth with many blues and sentimental songs rather than pure rock-and-roll. Popular music must reflect the way the masses feel. Listen to the new songs. I think they are telling us something about the changing mood of America.

The changes which I have suggested above are bound to be reflected on Wall Street. The dreams of riches are dissolving into doubts and questions. And the giant explosion of mutual funds buying too, will be subject to a cooling off. This is why I say that the 1965 statistics for mutual funds are probably going to stand for a long time to come.

* * *

From economist Melchior Palyi's column of June 28: "Bear in mind the inferiority complexes suffered by the Frenchmen of this generation. After 17 devaluations, the French franc had lost 98% of its purchasing power. When De Gaulle took over, the Bank of France had a negative gold reserve, like the British have at present—more debt to foreign countries than gold. Today, it has the second largest gold reserve in the world; the foreign claims left over are fully covered by dollars. The franc is not only a respectable currency, but can look the almighty dollar straight in the face—and give it a kick in the rear too. How soothing to the ruffled feelings of the Frenchmen, almost every Frenchman."

* * *

From the latest (July) BANK CREDIT ANALYST by A. Hamilton Bolton: "In terms of the overall period of credit contraction signalled as beginning around July 1965, we seem at the moment to be in an interim period of some temporary improvement. With current problems of tight money, need for credit restriction and curtailing of excessive demand, it is unlikely that a base can be laid for a sound monetary balance in what remains of 1966. It is a period we feel to take aggressive positions only on a short term basis with the full recognition that the most difficult part of the economic and monetary readjustment probably lies ahead."

* * *

From E. George Schaefer's Dow Theory Trader, July 2: "At Friday's closes ..... for the Averages, the Industrial Average closed 20.10 points below the close of a week ago. Even though we had a sharp rally, no doubt, considerable short covering took place on Friday. It seems to me, however, that our Summer rally has already come and gone as predicted in these pages last week. I now look for a new selling stampede and new 1966 lows for the Industrial Average during the week ahead, below the 1966 low close of 864.14, and the gradual development of semi-panic and finally panic selling before this Summer is out."

* * *

From Drew Odd Lot Studies, July 2: "In view of the suspicious developments of a week ago, the appearance of more overt weakness was not surprising. With the pattern as it now appears, it is difficult to visualize a worthwhile turn to the upside and the intermediate trend is questionable. The amplitude of movements is essentially unpredictable, but a third downward leg within the limits indicated so far could carry to the 810-830 range. In any event, we continue to believe that the market has been making a broad top for some time and is headed ultimately, at least, for more substantial correction."

* * *

From John W. Schulz's column in the July 1 Forbes: "I suspect that this pattern is being repeated now. As this goes to press, it looks as though the spring low was established at Dow 864 on May 17, early enough to be typical of a bear-market year. This may also mean that the recovery will reach its peak relatively early in the summer, perhaps around the middle or in the second half of July. Another reason for thinking so is that high interest rates and tight money may keep an unusually large portion of midyear cash receipts out of the stock market. So, as I wrote here in the last issue, there seems to be little basis for hoping that this summer the industrial average will push through the 910-940 range by much, if at all."

MONEY RATES: Subscribers are probably getting sick of my constant dwelling on money rates, but last week did prove to be an important week on the money front. Biggest news was the jump in 91-day Treasury yields (see inclosed clip) to 4.73%, highest yield for the bills in history (are they reflecting another rise in the discount rate?). Most banks raised their prime rate (the borrowing rate to the highest-grade borrowers) to 5 3/4%, and this means pressure throughout the economy. Finally, against the wishes of the Federal Home Loan Board, most California Savings & Loan Associations raised their regular divident rate to 5¼%, and 5 3/4% on bonus accounts. Even this, it was admitted, would do little to attract new savings in the face of vicious commercial banks competition.

Treasury Bill Yield Hits a Record 4.731% On the 13-Week Issue

Return on 26-Week Bills Rises Sharply to 4.915%, Matching High for Year Set March 14

By a WALL STREET JOURNAL *Staff Reporter*

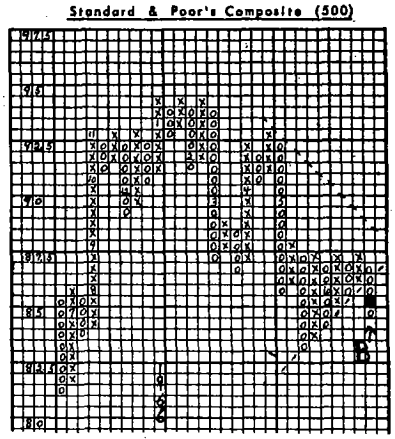
WASHINGTON — Yields on the Treasury's latest issue of 13-week bills soared to a record and those on the 26-week bills increased sharply.

The return to investors on the 13-week issue rose to 4.731%, topping the previous high of 4.718% set March 14. The average yield at the previous auction was 4.435%.

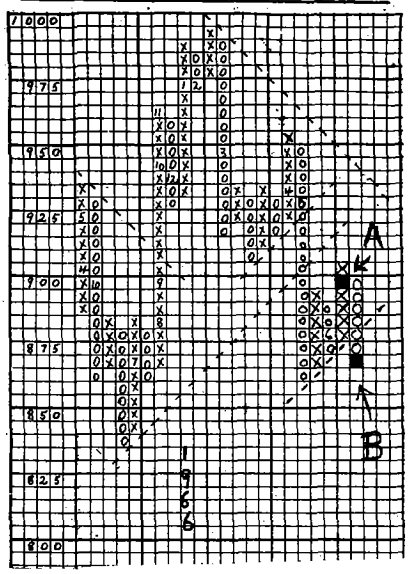
The average yield on the companion 26-week issue climbed to 4.915%, matching the year's high on March 14 and was sharply above the 4.610% at the previous auction. The record for 26 week bills, set Jan. 11, 1960, is 4.989%.

INTERESTING COMPARISONS: The two point-and-figure charts at right illustrate the massive tops which have formed in both the D-J Industrial Average and the broader Standard & Poor 500 Composite Average. Charts are courtesy of Chartcraft, Larchmont, N.Y. The two charts depict rallying movements by vertical rows of X's and declining movements by vertical rows of O's. P & F charts do not take the time factor into account, but only actual motion is shown. Thus, great activity and movement within a few days may consume three or four vertical lines on the chart while dullness over a period of months may not even show on the chart. This allows for great compression in P & F work, with a single P & F chart often being able to show what page after page of bar-line charts show.

Standard & Poor's Composite (500)



DOW - JONES INDUSTRIAL AVERAGE

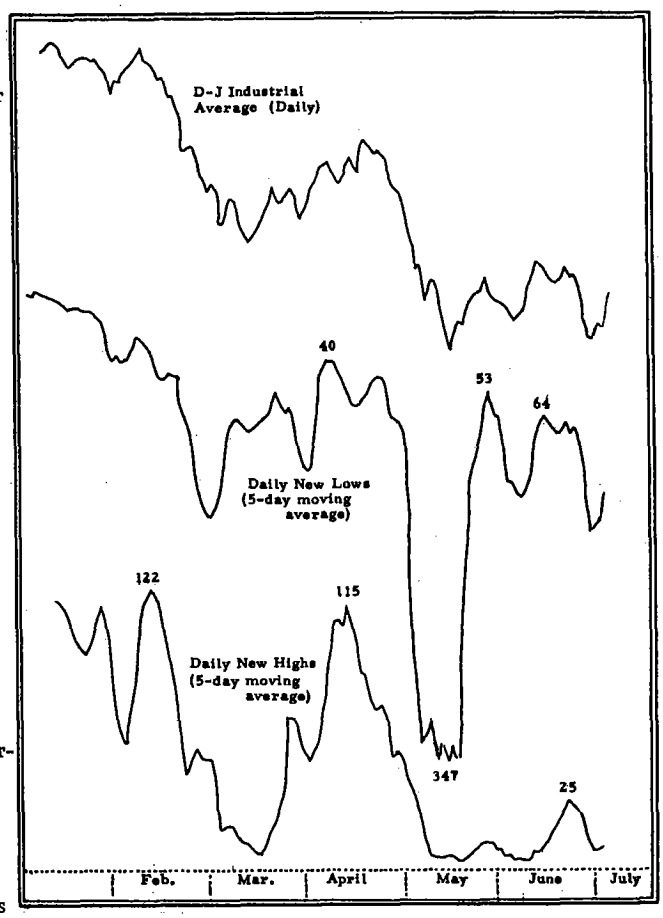


The chart of the Dow is a 15 point reversal chart with each boxing equalling 5 points. In other words, a full 15 point reversal up or down is needed before a new vertical line of X's or O's is drawn in. The S & P chart is a 1½ point reversal chart with each box equalling ½ point.

One item of particular interest in the comparison of the Dow and the S & P charts is the respective action as shown since June of this year. Note that at 900 (designated by black square A on chart) the Dow gave a "bullish signal" by breaking out above the previous rally peak (i.e. above the top of the preceding column of X's). But note also that the same action did not occur in the S & P 500. Subsequently at B (870 on the Dow and 85.5 on S & P) "sell signals" were given as the two Averages broke below the bottom of the preceding rows of O's. Here the S & P Average did confirm the bearish indications of the Dow. These two major indices are now in harmony and are both bearish. As matters now stand, the Dow would have to rise to an hourly 910 and the S & P 500 would have to rise to 88.0 before they would turn bullish again.

HIGHS AND LOWS: One of the best gauges of the momentum of a movement is through the daily computations of the new highs and lows. In a powerful upward movement, the tendency is for stock after stock to break into new high ground, and there is a further tendency for those stocks which have "broken out" to continue their upward path and thus make the new high list. Thus in a true bull movement the new high list will expand, with each minor recession and subsequent new peaks producing more and more new highs. The exact opposite is the case during a strong bear movement.

However, in a rally in a bear market the sluggishness of the new highs often provides evidence of weakness. One reason for this is that bear market rallies tend to be selective, often viciously selective, and a small number of new highs are usually recorded. Further, many stocks will provide "false break outs" during a bear rally, and this means that they will jump temporarily to new highs, only to "top out" and be distributed. Thus, there is often little continuity to the rise during a bear market rally, and many speculators will find themselves caught in stocks which seemingly "turned bullish," then turned down to lock the hapless speculator in with increasing losses.

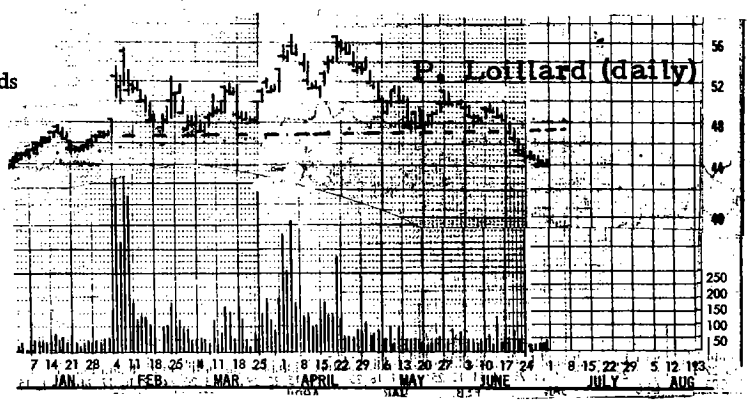


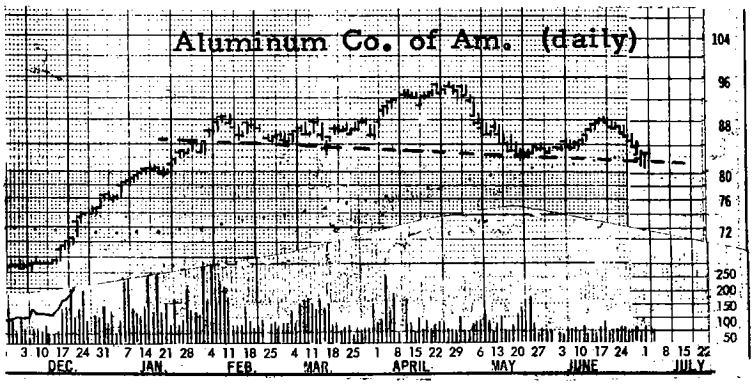
The accompanying chart constitutes a history of the daily new highs and lows (the indexes are smoothed out in the form of 5-day moving averages) from early 1966 to date. Two things are immediately apparent on the chart. First since early 1966 each rally has produced a greater level of new lows. Thus the April rally reduced new lows to 40, the May peak brought in 53 new lows, and the June high (for the Dow) showed 64 new lows. During last week's decline new lows expanded to a 5-day average of 112 (against the peak of 347 new lows at the May low).

The reverse was seen in new highs. The February peak for the Dow brought in 122 new highs. The April rally peak produced 115 new highs. The most recent June high showed only 25 new highs, less than 25% the number seen at the previous rally peak. Thus we note that the peak of downside intensity was seen in May with 347 new lows, while the peak of intensity on the upside was seen in February with 122 new highs. These are the figures to watch during the next broad upward or downward swing, and they constitute important "marker points" for the bear market so far.

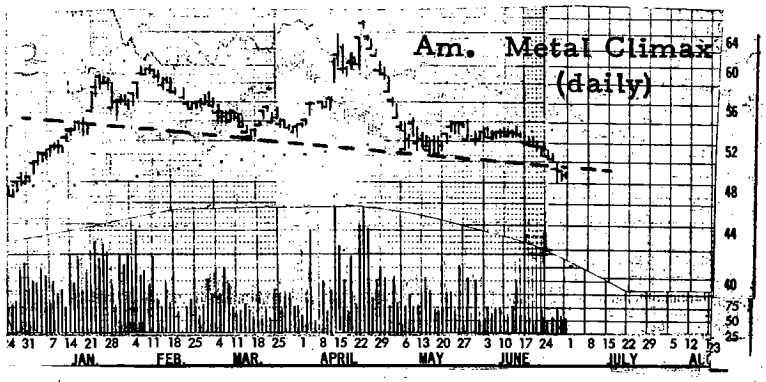
STOCKS: Only 16% of the stock groups are still bullish, and these include Electronics, Integrated Domestic Oils, Tires & Rubber Goods and Vegetable Oils. As often stated in these Letters, during bull movements it is normal for 50% or more of the groups to be in bullish or expanding phases.

I have included four daily charts on this page (charts courtesy of Traders Research, 1431 Pearl St., Alton, Ill. 62003). What I want to illustrate here is the implications of volume in individual stock analysis. The head-and-shoulders top is one of the commonest and most valid of the distribution patterns, and it is often seen at general market tops. Nevertheless, many neophytes are badly mauled on the short side by this apparent top-out pattern. In the H & S top, it is extremely important to identify the volume pattern correctly. In the true H & S top, volume is highest on the right shoulder, it contracts at the head, and it should contract even further on the third rally (i.e. the right shoulder). Volume may or may not expand when the neckline (dashed line) is broken, as stocks often simply fall of their own weight once they are fully distributed.





Note the perfect volume implications in Lorillard and Aluminum. In each case volume contracted as the successive H & S rallies developed. As such they appear to be valid and bearish top-out patterns. But Am. Metal produced a spurt of volume at the April head. Even though the stock subsequently crumbled, such volume at the top is suspect. In this case, however, the pattern proved to be a valid top-out pattern. Berman Leasing did not cave in on a H & S pattern, but here volume proved to be an indication of growing weakness. Volume surged during the December top, volume contracted dramatically during the second rally in April, and on the May-June rally attempt volume fizzled completely. The implication was that rising prices in Berman could not attract a following. This is usually a sign of real weakness.



CONCLUSION: watch volume closely in individual stocks. There are usually a few stocks which show perfect volume characteristics, and when shorting these are the stocks to follow.

LATE NOTES: (Written Thursday, July 7, after the opening)... On last week's weakness, Industrials broke below their preceding June low (see chart 1), but Rails refused to confirm. This technical non-confirmation resulted in a sharp reversal with Industrial up over 13 points on July 6. With the minor trend up, our eyes will be focussed on the preceding peaks of 903.22 (Industrials)and 232.33 (Rails). A bettering of those highs would undoubtedly arouse a great deal of optimism and bullishness on Wall Street, but I warn subscribers against embracing the bull thesis. This is still a confirmed primary bear market, and just as reactions in bull markets are deceptive, so (upward) reactions in bear markets can be deceptive. When this rally ends, the resultant turn to the downside promises to sudden, violent and costly. I would accept all upside action as an opportunity to move into a cash position.